Inflection Commentary

INFLECTION
Alternative Assets

Inflection Performance: February 2016

How High Can a Dead Cat Bounce?

After many months of unrelenting negative global economic news flow, equity markets reversed mid-month with a U-turn in the price of oil triggering what appears to be a classic 'dead cat bounce'. In the sometimes colourful world of market slang, a dead cat bounce is a temporary recovery in prices after a substantial fall, caused by investors buying in order to cover their short positions.

There's no knowing how long this particular cat will continue its acrobatics, but eventually its demise will very likely prove fatal. With continuing weak global growth, negative interest rates in large swaths of the sovereign debt market, and central banks' tool boxes emptied of all the best tools, there appears to be little likelihood in the near term of reigniting the kind of growth that fuels true stock rallies.

The Inflection Strategic Opportunities Fund ('ISOF') employs various forms of hedging to protect the portfolio and profit across various market environments. Unfortunately, February was one of those months when rapidly changing market dynamics made it extremely difficult for alternative strategies to profit either from hedges or fundamental value-drivers. Our first line of hedges benefited from the volatility and surprise reversals during the month, but not enough to overcome what we believe was a temporary and somewhat irrational mispricing of fundamentally valued assets. Ironically, had the volatility been worse, our second line of hedges would have been triggered and the portfolio would have benefited far more.

On the macro-economic front, the first half of February continued January's turbulence as equities continued to sell off amidst continued dour sentiment. Despite positive developments like further easing from the Bank of Japan at the end of January, Mr Draghi's announcement that there would not be a Basel IV, relatively good earnings out of the US, and stabilization in China, it was only in the 3rd week of February when oil prices began to rebound and market sentiment changed. The second half of the month saw markets rally back strongly, with European and Asian indices recovering most of the losses from the early part of February and the S&P500 ending the month only slightly down.

Until mid-February, investors were pricing in a growing probability of recession, continuing ineffective central-bank policies, and an increasing number of energy bankruptcies. Many funds had therefore sold their more growth-oriented, fundamentally better long positions and added to shorts that they believed would be most affected by a global slowdown. Instead, the Chinese currency stabilized, growth indicators rebounded, credit markets turned, and the relative rebound in the price of oil allowed levered energy companies to buy time by raising additional equity.

Inflection Commentary

INFLECTION
Alternative Assets

Inflection Performance: February 2016

Investors who had positioned themselves for a slowing world economy scrambled to reduce the very same short positions that had worked well during the first six weeks of the year. The race to cover short positions in turn caused sizeable outperformance among popular short-interest names while growth-oriented longs failed to participate in the rally. The moves were unusually large due to the combination of unwinding equity portfolios and volatile macro shifts.

The reversal caught many by surprise, especially as it appeared to be more based on the price of oil than on fundamental macro-economic indicators which continue to signal weakness, especially outside of the US. Perhaps it is an indication of the current state of confusion that investors are being led into distraction, but usually anomalies like this correct. We believe that despite the recovering mood of the US economy, there are still substantial risks plaguing some of the US's biggest trading partners that may seriously impact the US. We therefore remain conservatively positioned and willing to keep exposures that may in months like February provide small losses but will, we believe, provide excellent upside optionality once the forced sellers are flushed out.

In February ISOF's net return was -2.77% bringing our year to date net return to -3.67%. By comparison, the HFRI Fund Weighted Composite Index returned 0.00% for February (-2.55% for the year). The S&P TSX Index returned 2.61% for the month (0.24% for 2016) and the Barclays Global Aggregate Bond Index Index gained 2.23% in February (3.12% for the year).

Since inception in October 2010 ISOF has produced a return of 28.75% outperforming the HFRI Hedge Fund Index by 13.73%, the TSX Index by 5.81%, and the Barclays Global Aggregate Bond Index by 22.36%. Over that period ISOF's Sharpe ratio was 0.73 and its correlation to the S&P TSX Index was 0.62.

ISOF's disappointing performance for the month was predominantly due to negative stock-picking alpha by our market neutral managers. The source of some of our managers' apparent correlation in February appears to have been more a result of similarly robust risk protocols than of similar fundamental thinking: As short positions turned negative, drawdown limits were triggered, gross exposures were reduced, and reduced liquidity further exacerbated losses. We've observed this phenomenon across different strategies in the past, and although it's duration cannot be known in advance, it almost always results in attractive alpha opportunities coming out the other side.

Twelve of the 19 funds in our portfolio have assets under management under USD 1 billion, reflecting our preference for nimble niche players, especially during periods when popular trades favoured by larger funds appear crowded and at risk of excessive correlation. With so many factors contributing to the instability of the markets, our volatility-focused managers added 0.87% net to the fund in February. More importantly, we continue to uncover interesting niche strategies that exhibit the high levels of risk-reward asymmetry that we value and the ability to produce outsized returns in the kind of volatile environments we continue to expect.

Inflection Commentary

INFLECTION
Alternative Assets

Inflection Performance: February 2016

As we put February behind us, we take solace in most of our managers having long track records that include similar periods of drawdown, and accept that there will be months when market dynamics make it extremely difficult for providers of alternative returns to make money. Though February was challenging, February's events will likely be beneficial to the portfolio in the long run: Large competitors will likely reduce their number of portfolio managers and cut back overlapping strategies; smaller players and newer entrants will probably close or shrink; and leverage will likely be reduced. All of these factors should improve the opportunity set for our tightly focused managers and provide a robust source of profit when this elastic kitty finally gives up the ghost.

Sincerely,

The Inflection Team

The Inflection Strategic Opportunities Fund (ISOF) invests in a broad array of carefully selected hedge fund strategies in order to capitalize on dislocations and market opportunities. The Fund has a global mandate and focuses primarily on the Americas, Europe and Asia, providing access to the expertise of hedge fund managers in identifying what we believe are exceptional investment opportunities throughout the world. Some taxable investors may find that the Fund's option structure has significant tax benefits. Please refer to the attached Factsheet for additional information.

Inflection Management Inc.
1981 West 19th Avenue
Vancouver, British Columbia
Canada V6J 2P2

Tel: 604.730.9147 Fax: 604.730.9149
www.inflectionmanagement.com